UPREME COURT. U. S.

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No. 1142

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

In the Matter of
THE NEW YORK, NEW HAVEN AND HARTFORD RAILROAD COMPANY, DEBTOR

ABEX CORP., ARTHUR ANDERSEN & COMPANY, BETHLEHEM STEEL CORPORATION, *et al.*,
Petitioners,

against

TRUSTEE OF THE PROPERTY OF THE NEW YORK, NEW HAVEN AND HARTFORD RAILROAD COMPANY, *et al.*,
Respondents.

BRIEF OF RICHARD JOYCE SMITH, TRUSTEE OF THE PROPERTY OF THE DEBTOR, IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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April 8, 1969

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QUESTION PRESENTED

Should the so-called six months rule, which in essence sanctions preferential payment of certain unsecured claims for materials, supplies and services furnished to a railroad prior to the filing of a petition under Section 77 of the Bank-

ruptcy Act, from net income in the hands of its reorganization trustee, be expanded to require preferential payment of such claims out of the corpus of mortgaged property when there has been neither net income nor diversion of income for the benefit of the mortgagees?

STATEMENT OF THE CASE

The Debtor, The New York, New Haven and Hartford Railroad Company (New Haven), on July 7, 1961, petitioned for reorganization under Section 77 of the Bankruptcy Act. On the date of filing, the Debtor's current assets aggregated $23,380,000, and its current liabilities exceeded $59,000,000. The District Court found that "all of the current assets were more than offset by current liabilities totalling substantially in excess of $25,000,000 which the Trustees were required to pay and did pay or which were accrued taxes, payment of which has been deferred by court order." (Petition, p.21A.) The court directed payment of certain items whose payment was essential to continued operation, such as interline accounts, since otherwise freight movements destined to the New Haven would have been put on a prepaid basis. Wages were paid for the same reason.

At no time during the reorganization, nor for some years prior thereto, did the New Haven have either net railway operating income or income available for fixed charges. The Trustees were able to continue operations from the inception of the reorganization until the sale of the Debtor's assets to Penn Central on December 31, 1968, only by borrowing $26,500,000 on Trustees' certificates ($12,500,000 of which are still outstanding[1] and are senior

[1]Trustees' certificates in the amount of $14,000,000, reflecting loans from Penn Central, were cancelled in conjunction with the sale of the Debtor's assets to Penn Central.

to the liens of the New Haven's mortgages); by deferring payment of certain administrative expenses (notably, real estate taxes now aggregating more than $20,000,000); and by the receipt of substantial grants from public authorities.

All of the Debtor's property (with the exception of income, cash and receivables prior to the happening of an event of default) is subject to the liens of its two system mortgages. Petitioners are unsecured creditors who furnished materials, supplies and services (other than labor) to the Debtor during the six months prior to the date of the filing of its petition; and at that time, the claims of all the six months creditors (with the exception of per diem creditors) aggregated about $4,670,000. (Petition, pp. 4A, 28A.)

ARGUMENT

The decision below applies the six months rule as developed by this Court.

The so-called six months rule, developed in the equity receiverships of the late nineteenth century, in substance authorizes preferential payment of certain claims for material, supplies and services furnished to a debtor during a short period, usually stated as six months, prior to the filing of a petition for reorganization, if and only if there is a "current debt fund" from which such claims may be paid.[2] Under the controlling precedents such a fund may consist of a debtor's unmortgaged assets or of "net" or "surplus" income in the hands of its trustees; if such

[2]The rule was made applicable to reorganizations under Section 77 by the provision of subsection (b) that, "For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors." See, *e.g., In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir. 1964).

income has been "diverted" for the benefit of mortgagees, for example, by being expended for payments of interest on their bonds or for capital improvements which increase the value of their security, the corpus of the mortgaged property may be invaded to the extent of such diversion. *Fosdick* v. *Schall,* 99 U.S. 235 (1879); *Southern Ry.* v. *Carnegie Steel Co.,* 176 U.S. 257 (1900); *Gregg* v. *Metropolitan Trust Company,* 197 U.S. 183 (1905); see Fitz-Gibbon, *The Present Status of the Six-Months' Rule,* 34 Colum. L. Rev. 230, 241-42 (1934). Both Courts below found that there was neither a "current debt fund" nor a "diversion" — and thus that there was no source from which preferential payment of Petitioners' claims could properly be made and no basis for payment out of the corpus of the mortgaged property.

There is no justification in statutes or public policy for overruling this Court's precedents.

Petitioners apparently concede the correctness of these holdings, abandoning their attempts to devise a system of accounting which would produce from the New Haven's deficits "surplus income" from which, under *Gregg* v. *Metropolitan Trust Company, supra,* and other controlling precedents, their claims could be paid. They now argue that, regardless of the existence of a "current debt fund", "the post-*Gregg* enlargements of national transportation policy" (Petition, p.10) require this Court to overrule *Gregg,* the last holding by this Court (Petition, pp.6-7), and to hold that "the claims of those who have furnished insolvent railroads with the materials, supplies or services necessary for the safe continuation of their common-carrier activities should be entitled to a priority of payment in reorganization without regard to the adequacy of net railroad operating income for this purpose (that is, without regard to any metaphysical 'fund' requirement)." (Petition, pp. 11-12.)

There is neither occasion nor justification for any such action by the Court.

In the first place, the only warrant for the application of the rule to reorganizations under Section 77 is the reference in subsection (b) to "claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition." It is clear from the language of the statute that Congress intended no such dramatic expansion of those priorities as Petitioners now propose. There is, moreover, a strong general presumption against the creation of novel preferences in bankruptcy proceedings: "If one claimant is to be preferred over others, the purpose should be clear from the statute." *Nathanson* v. *NLRB,* 344 U.S. 25, 29 (1952).

Nothing in the national transportation policy cited by Petitioners requires or would be furthered by the creation of the extraordinary preference for which they contend, which would require payment from the corpus of the mortgaged property of all unsecured supply claims arising within six months prior to reorganization. No doubt national policy does favor the uninterrupted and safe operation of railroads whose service cannot be abandoned consistent with the public interest. This policy is best served when a failing railroad has prompt recourse to Section 77, one of whose principal purposes is to insure the continued operation of the railroad by assuring the current payment of all operating expenses incurred *under the Court's supervision.* Under that statute a railroad debtor, no matter how serious its financial straits, can obtain whatever materials and services it needs after the petition is filed.

Any extension of the rule to enable a hopelessly insolvent railroad to incur additional debt without judicial supervision

is opposed to sound public policy. As the District Court pointed out, "the New Haven Railroad in the interest of its creditors, its employees and the public should have petitioned in reorganization long before it did. The grave problems which have beset the reorganization would have been less acute and infinitely more manageable if bankruptcy had not been put off until its cash was almost entirely depleted, credit was practically gone, maintenance was down and in all other respects the bottom was out of the barrel." (Petition, p.29A.) In *Meyers* v. *Jay Street Connecting Railroad,* 259 F.2d 532 (2d Cir. 1958), upon which Petitioners place much reliance (Petition, p.10), the Court pointed out that the proper remedy for a railroad whose cash shortage threatened to force an abandonment of service was the filing of a petition under Section 77. 259 F.2d at 536.

Validity of "springing liens" is not in issue.

Part IB of Petitioners' Argument is not addressed to any aspect of the holding below. Neither the Court of Appeals nor the District Court decided that the so-called "springing liens" were valid; indeed, the District Court indicated *obiter* that they were not. (Petition, p.22A.) They held that, regardless of the validity, as against six months claimants, of the provisions of the Debtor's system mortgages which subjected such current assets as cash and receivables to the liens of the mortgages upon the happening of an event of default, the Debtor's current assets at the date of the filing of the petition were more than offset by current liabilities for such items as wages and traffic balances which had to be paid by the Trustees under the "necessity of payment rule" discussed *infra;* and by accrued taxes which will have to be discharged before the reorganization is terminated.

There is no conflict among the Circuits.

The holding of *Southern Ry.* v. *Flournoy*, 301 F.2d 847 (4th Cir. 1962) is not in conflict with the decision of the Second Circuit. Although the opinion in *Flournoy* contains a dictum which confuses the six months rule with the quite distinct necessity of payment rule, it is clearly an application of the latter.[3] The necessity of payment rule, which is not involved in the present litigation, was first enunciated in *Miltenberger* v. *Logansport Ry.*, 106 U.S. 286 (1882). It is founded not upon equities, but upon a "pistol at the head" theory: payment by the trustees of certain unsecured claims, such as that of a sole supplier of an essential material, may be necessary to the trustees' continued operation of the railroad, since otherwise the claimant will refuse to do further business with the trustees. Thus, payment is required regardless of the age of the claim or any of the other prerequisites to the applicability of the six months rule. "The ground of such allowance as was made [in *Miltenberger*] was not merely that the supplies were necessary for the preservation of the road, but that payment was necessary to the business of the road, — a very different proposition." Holmes, J., in *Gregg* v. *Metropolitan Trust Co., supra,* at p.187.

The "necessity of payment" rule was frequently applied to interline balances, which were in fact the claims preferred in *Flournoy*, while the claim which was denied preference in that case was that of a fuel supplier, such claims having usually been held not to be within the necessity of payment rule. The Fourth Circuit's opinion shows that it relied entirely upon *Miltenberger* and the decisions of the lower federal courts which followed that case and that it

[3]Counsel for some Petitioners characterized the *Flournoy* decision as "illogical" in their main brief to the Second Circuit (Brief of Cravath, Swaine & Moore, p.17).

justified the payment of the interline balances on the ground that, had such payment not been made, the other lines would have demanded advance payments which the debtor could not have made: "That other lines could then have refused traffic coming to and from [the debtor] constitutes an immediate necessity of payment threatening the debtor." 301 F.2d at 854.

In sum, the decision of the Second Circuit follows the decision of this Court in the *Gregg* case and is clearly correct. It does not conflict with any holding of a Court of Appeals. There is no warrant in either statute or public policy for the creation of the novel and extraordinary preference which Petitioners seek.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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